

Letter of Findings Number: 02-20110323
Income Tax
For Tax Years 2007-08

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ISSUE

I. Income Tax–Deductions.

Authority: Adler v. Comm'r, T.C. Memo. 2010-47, 2010 WL 934267 (U.S. Tax Ct., 2010); Alemasov v. Comm'r, T.C. Memo. 2007-130, 2007 WL 1484527 (U.S. Tax Ct., 2007); I.R.C. § 63; I.R.C. § 162; I.R.C. § 6001; IC § 6-3-1-3.5; IC § 6-8.1-5-1; IC § 6-8.1-5-4.

Taxpayer protests the imposition of individual income tax.

STATEMENT OF FACTS

Taxpayer is an irrevocable trust filing as an individual shareholder of an S corporation ("S corp") with Indiana income. The Indiana Department of Revenue ("Department") determined that S corp took deductions on its federal income tax returns for 2007 and 2008 and that this resulted in inaccurate Indiana individual income tax returns for S corp shareholders for 2007 and 2008. The Department therefore issued proposed assessments for individual income tax for both years. Taxpayer protests that the Internal Revenue Service ("IRS") audited S corp's federal return for 2008 and made no changes. Therefore, Taxpayer asserts, the Department is compelled to accept what was filed on S corp's federal returns since both years are substantially similar. An administrative hearing was held and this Letter of Findings results. The hearing was held open to allow time for the submission of supporting documentation. After two months, the Hearing Officer called to remind Taxpayer's representative that the documentation had still not arrived. After ten more days without receiving the documentation or any contact on the matter, the Hearing Officer wrote the Letter of Findings based on the materials contained in the protest file. Further facts will be supplied as required.

I. Income Tax–Deductions.

DISCUSSION

Taxpayer protests the Department's adjustments to Taxpayer's reported Indiana income taxes for the tax years 2007 and 2008. Taxpayer states that Indiana income begins with federally reported income and only certain adjustments are allowed to those federally-reported numbers under Indiana statutes. Taxpayer also provided a letter from an IRS agent which states that the agent had completed an examination of Taxpayer's federal return for 2008 and was proposing no changes. According to Taxpayer, this is the final word on the 2008 federal return and, since the 2007 federal return was virtually identical to the 2008 federal return, the Department should accept both years as reported. The only exception to this position is the inclusion of the salaries for two ranch hands at a ranch outside of Indiana on S corp's 2007 return, which Taxpayer agrees should not have been deducted on the Indiana return. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

As in effect for the tax years at issue, IC § 6-3-1-3.5 provided in relevant part:

When used in this article, the term "adjusted gross income" shall mean the following:

...

(b) In the case of corporations, the same as "taxable income" (as defined in Section 63 of the Internal Revenue Code) adjusted as follows:

....

I.R.C. § 63(a) states in relevant part:

Except as provided in subsection (b), for purposes of this subtitle, the term "taxable income" means gross income minus the deductions allowed by this chapter (other than the standard deduction).

I.R.C. § 162(a) provides:

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

- (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;
- (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and
- (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any

Delegate and Resident Commissioner) within the State, congressional district, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of \$3,000. For purposes of paragraph (2), the taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year. The preceding sentence shall not apply to any Federal employee during any period for which such employee is certified by the Attorney General (or the designee thereof) as traveling on behalf of the United States in temporary duty status to investigate or prosecute, or provide support services for the investigation or prosecution of, a Federal crime.

Next, IC § 6-8.1-5-4 states:

(a) Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks.

(b) A person must retain the books and records described in subsection (a), and any state or federal tax return that the person has filed:

- (1) for an unlimited period, if the person fails to file a return or receives notice from the department that the person has filed a suspected fraudulent return, or an unsigned or substantially blank return; or
- (2) in all other cases, for a period of at least three (3) years after the date the final payment of the particular tax liability was due, unless after an audit, the department consents to earlier destruction.

In addition, if the limitation on assessments provided in section 2 of this chapter is extended beyond three (3) years for a particular tax liability, the person must retain the books and records until the assessment period is over.

In *Adler v. Comm'r*, T.C. Memo. 2010-47, 2010 WL 934267 *10 (U.S. Tax Ct., 2010), the court reviewed a petitioner's claim that he was entitled to claim business expenses attributable to alleged use of vehicle as part of his wife's rubber-stamping home business. Petitioner provided only his wife's testimony, but did not provide any records or documentation regarding business use of the vehicle or other travel and business expenses. *Id.* The court pointed to I.R.C. § 6001 which "requires the taxpayer to maintain records sufficient to substantiate his claimed deductions." *Id.*

In *Alemasov v. Comm'r*, T.C. Memo. 2007-130, 2007 WL 1484527 (U.S. Tax Ct., 2007), the court reviewed the petitioner's claim that business expenses shown on petitioner's tax return were paid or incurred during the taxable year and that the expenses were "ordinary and necessary" to the petitioner's business under I.R.C. § 162(a). *Id.* 2. In reviewing petitioner's claims, the court noted that any deductions are a matter of legislative grace, and the petitioner had the burden of proving entitlement to any claimed deduction including the burden of substantiation. *Id.*

In the instant case, the Department reviewed the deductions taken by S corp and determined that they were not "ordinary and necessary" for S corp's business, as required by I.R.C. § 162(a), thus those amounts were not properly deducted from S corp's federal AGIT as provided by I.R.C. § 63(a). Since Indiana AGIT begins with federally-reported AGIT, as provided by IC § 6-3-1-3.5(b), those amounts were added back to S corp's Indiana income and the additional income then flowed through to Taxpayer's individual Indiana adjusted gross income. While Taxpayer did provide a letter from the IRS stating that there would be no federal adjustments to S corp's federal filing for 2008, that letter does not contain any detail regarding what the IRS was reviewing or for what reason it was reviewing S corp's return. Also, when requested to provide documentation supporting the claimed deductions, Taxpayer did not provide any documentation beyond the IRS letter regarding the 2008 tax year, as required by IC § 6-8.1-5-4, the I.R.C., and confirmed by the courts in *Adler* and *Alemasov*. Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

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